

# **SINO-AMERICAN RELATIONSHIP AFTER THE GLOBAL ECONOMIC SLOWDOWN**

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# **SINO-AMERICAN ECONOMIC RELATIONSHIP AFTER THE GLOBAL ECONOMIC SLOWDOWN**

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## LIST OF SYMBOLS AND ABBREVIATIONS

ARRA	American Recovery and Reinvestment Act
BWII	Bretton Woods II
SEZ	Special Economic Zone
SOE	State Owned Enterprise
USD	United States Dollar
WTO	World Trade Organization

## **SUMMARY**

The continued funding of America's persistent trade and fiscal deficits has sparked debate among international economists. One controversial explanation argues that East Asia is pursuing "Bretton Woods II" and funding American deficits as part of a greater development policy. This paper examines the Chinese policy response to the global economic crisis and finds that China's policy actions provide evidence for "Bretton Woods II." Furthermore, the Sino-American relationship is now characterized by codependence which has implications for the policy decisions of each country.



# **CHAPTER I**

## **PRESENCE AND ENDURANCE OF AMERICAN DEFICITS**

The large American current account and fiscal deficits are notable and puzzling traits of the international economic system. Indeed, during this decade the United States' current account rose from \$360 billion in 2000 to a peak of \$712 billion in 2006 and still finished 2009 at \$420 billion (U.S. BEA, U.S. International Transactions). The financial inflows necessary to close these deficits are large as well, reaching \$843 billion at their peak in 2007. Despite the difficult economic times that limit trade and financial flows the US still ran a \$420 billion current account deficit with \$197 billion in financial inflows (U.S. BEA, U.S. International Transactions). Researchers are currently divided in their explanations for the existence, durability and international willingness to finance these large deficits. It remains a puzzle, as large deficits should increase the risk of holding American debt and force American interest rates higher as investors require greater compensation for the greater risk. However, American deficits remain large and interest rates largely unimpacted.<sup>1</sup>

One explanation for the endurance of these high deficits and low interest rates involves a new formation of the Bretton Woods system. The original Bretton Woods was characterized by a less economically developed periphery- Japan and Europe- that attempted to reach the level of development of a more advanced center- the United States- through an economic development strategy that focused on exports to the center

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<sup>1</sup> Yield on the US 10-year bond is currently at 3.9%, down from the 6% it started the decade at.

(Eichengreen, 2004). To encourage exports, countries on the periphery promoted high levels of manufacturing investment while maintaining exchange rates that were undervalued relative to the center's currency. An undervalued exchange rate required other policy efforts including capital controls to prevent speculative inflows that could overwhelm the financial system. In addition, countering the forces that drove Japanese and European currency appreciation required their central banks to purchase American debt and accumulate a large amount of foreign exchange reserves.

In a controversial paper, Dooley et al. (2005) argue for what is now described as "Bretton Woods II" (BWII) because of its similarities with the previous system. In the newly constituted system, the United States remains at the center while East Asia replaces Japan and Europe on the periphery. Like Japan and Europe before them, East Asia's deliberate economic development strategy involves exports to the center, an undervalued exchange rate, capital controls and foreign exchange reserve accumulation. Dooley et al. (2005) assert that the motivation behind the East Asian emphasis on exports as a source of economic growth is because it subjects Chinese manufactures to the discipline of competing on the global market. Exports allow leaders on the periphery to incorporate global prices into their economies in order to ensure the development of an efficient capital stock and avoid the problems with make-work that plague other development strategies.

The main causal mechanism driving the system is East Asia's need to absorb underemployed labor (Dooley et al. 2007). To absorb this surplus, authorities set their national real wage rate below the global wage rate in order to attract investment. This attracts investment because it gives investors returns that are equal to the difference

between the two wage rates plus a normal return on capital. As investment grows, policymakers allow the real wage rate to increase as the underemployed labor stock is gradually incorporated into the global economy. As a result, the East Asian trade and capital flows that support the American deficits are driven by the absorption of the underemployed labor and can occur so long as the real wage adjustment stays on the same path.

Authorities can control the increase in the real wage rate through either domestic inflation or the real exchange rate. They can either maintain an undervalued currency peg and allow wage inflation to be higher than in the center or, under a managed float, can set wages at or below the center while allowing the currency to appreciate. As a result, Dooley et al. (2007) argue that those calling for an appreciation in the exchange rate due to capital inflows will only lead to Asian authorities maintaining their path of wage revaluation by controlling inflation. Therefore, Dooley et al. (2007) argue that it is irrelevant if East Asian countries pursue a fixed peg or managed float because the real wage rate will remain the same. So long as policymakers can control the wage rate, they generate the same growth in reserves.

Dooley et al. (2005) posit that this explains many aspects of the current international economic system. At the end of the period of adjustment East Asia will receive a fully employed labor stock that is internationally competitive. The potential losses on foreign exchange reserves that could occur when their currencies are revalued away from the United States Dollar (USD) fixed-exchange rate will be smaller than the gains they will receive from a more developed capital stock. This explains the East Asian accumulation of American foreign exchange, and why East Asian countries are willing to

absorb low-yielding American securities that could lose value if their currency appreciates relative to the USD. Currency and foreign exchange policy is subordinated to the overall developmental strategy. It also explains why the yield on American securities is not greater, despite large current account and fiscal deficits. Peripheral countries are financing these deficits to ensure their access to the American market. Lastly, because East Asia-particularly China-currently is attempting to absorb such a large supply of underemployed workers, the system is durable and will remain in existence until those workers are absorbed.

Critics of the new BWII system question its durability and ability to remain more than a temporary arrangement because of institutional weaknesses (Eichengreen 2004). To remain intact the system requires cooperation, as the first state to defect and sell its USD reserves reduces the value of the reserves of the other non-defecting countries. As a result, each country is incentivized to defect first and sell its reserves so as to not suffer large losses. Eichengreen (2004) notes that during the original Bretton Woods the Europeans had created the first collective transnational institutions that eventually became the European Union. This enabled the necessary cooperation that allowed the system to survive as long as it did. In contrast, Asia contains no collective transnational institutions with enforcement power.

In addition, at the time of the original Bretton Woods, the European countries were more homogenous in their economic progress, leading them to have similar economic interests that allowed them to act in unison (Eichengreen, 2004). Lardy (2004) echoes the concern that the differing levels of development will undermine the system by noting that China is the only East Asian state that completely fits under the Bretton

Woods II framework. For example, on many economic characteristics the developed and labor-short Japan is the opposite of developing and labor-abundant China. As a result, the two do not seem as if they should appear under the same theory. Similarly the economies of Taiwan, Hong Kong, Korea, Singapore and Thailand contain differences that prevent their easy grouping and do not neatly fit into the Bretton Woods 2 framework.

The system is also fragile because the United States shows little desire to restrain its deficits. The United States policy of financing its deficits through low-yielding dollar debt will lead to the depreciation of the dollar and a subsequent decline in the value of dollar-denominated assets (Roubini and Setser, 2005). The longer an official central bank such as the PBoC continues to purchase American assets, the larger the losses will be when the Yuan appreciates. As deficits remain and the United States' need for financing continues, it becomes more likely that creditors demand better terms for financing to compensate for the increased risk of capital loss (Obstfeld and Rogoff, 2007) (Eichengreen, 2004) ( Roubini and Setser,2005).

There is also disagreement over the effectiveness of capital controls and financial repression. Per Dooley (2007) capital controls and financial repression are necessary to keep East Asian wages from increasing too rapidly and pushing East Asia from their real wage rate adjustment path. However, Eichengreen (2004) argues that capital controls are no longer as effective, since capital can now move more freely than during the period of the original Bretton Woods. If capital controls are not maintained, China will be forced to revalue its currency, ending the Bretton Woods system. Roubini and Setser (2005) agree, and argue that the PBoC is having difficulty sterilizing capital inflows, leading to the risk of runaway inflation. In addition, the large capital inflows that China receives require

sterilization through the purchase of USD-denominated assets leaving the PBoC with greater downside in the event that the Yuan appreciates.

This paper examines the policy response of China to the global economic crisis in order to determine if its actions provide any evidence for the existence or durability of the Bretton Woods II system.<sup>2</sup> Because of the large governmental role directing a national development strategy outlined in BWII, it is important to examine government actions. This is especially important in response to important crisis and events in order to determine if prior arguments remain relevant as shifts in policy could occur due to the crisis. This paper argues that China's policy response to the global economic crisis of 2008, including maintaining an undervalued currency peg, supporting exports and increasing manufacturing investment, is consistent with the continued existence of the BWII system.

This paper contributes to the economic debate over the BWII system. The existing literature does not examine the BWII theory to see if it is consistent with the policies that China implements in response to the global economic crisis. As the crisis unfolded, policy with the goal of restarting the Chinese economy can provide insight into the validity of BWII by revealing what economic sectors are considered important and what China considers to be its main sources of economic growth and development. By providing evidence for the BWII system, this work is relevant to international economists and also contributes to the debate over the existence and endurance of deficits and how

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<sup>2</sup> While BWII is a theory on East Asia, China's large population, economy and high economic growth play such a critical role in the functioning of BWII that it is impossible to imagine BWII remaining viable as a theory if it cannot explain China's actions.

long it can take for them to adjust to equilibrium. This also provides evidence in the debate between the effectiveness of the standard inter-temporal consumption model of trade to predict economic outcomes.

Lastly, by contributing to the theoretical understanding of the economic relationship between the United States and China this work can lead to practical insights that provide useful information for the construction of either American or Chinese policy. Since it initiated economic reforms in 1978, China has experienced a high rate of economic growth and poverty reduction. Over this period of time, China's GDP increased from \$148 billion in 1978 to over \$4.4 billion by 2008 (World Bank, World Development Indicators, 2008) to become one of the wealthiest states in the world. As it grew, China's economic connections with the United States strengthened and in 2009 the two countries traded goods that totaled over \$365 billion in value (United States International Trade Commission, Dataweb, 2009). Understanding the Sino-American economic relationship helps policymakers understand the interests of each country in other areas such as North Korea's nuclear program (Sanger, 2009, May 15) or the Copenhagen climate talks (Broder, 2009, December 18).

This paper is organized as follows. Section two examines China's recent trends of investment and export-promotion that characterize China's economic development. Section three investigates China's policy response to the global economic crisis, a policy response that is consistent with WWII. It also examines the American response to the global economic crisis and the influence on Sino-American trade pattern. Section four argues that the two countries are now codependent. It discusses the implications of that relationship and identifies potential sources of tension that might arise.





## **CHAPTER II**

### **CHINA'S EXPORT AND INVESTMENT LED GROWTH**

China's desire to be an important actor in the global economy was a direct result of the failure of past economic models to generate growth. Maoist isolation prevented the adoption of new technologies and stunted China's technological development. The result was a poorly developed capital stock that was incapable of producing goods that were competitive on the international market. Shifting towards global integration allowed China to access and adopt new technologies to improve its capital stock as it moved away from isolation to become a global trading power.

The end result is an economic system that is institutionalized to encourage investment in manufacturing for export-led growth. China's economy is marked by interconnected savings and investment policies that couple with currency policy to promote Chinese exports and investment. (Prasad and Rajan, 2008). This is analogous to the original Bretton Woods, as in both eras export and investment-led growth is a social compact that involves workers agreeing to lower wage growth. In return, they receive higher living standards later as the result of higher rates of investment and export growth (Eichengren, 2004).

From the start of the reform process, and consistent with the BWII framework, China placed particular emphasis on exports. The intent was to copy the export-led growth of other East Asian countries, notably Hong Kong, South Korea, Singapore and Taiwan (Naughton, 2007). The first major policy initiative with a large impact on Chinese exports occurred in 1985 with the creation of four "Special Economic Zones"

(SEZ) as part of the Coastal Development Strategy. The SEZs were granted preferential tax treatment while relative freedom was granted to the foreign firms that set up business operations in the SEZs. In addition, foreign investors were allowed to bring in imports free of tariffs provided that they were destined to be further processed and exported (Chow, 2007). This provided the foundation for the creation of an Export Processing trading regime and the expansion of foreign investment enterprises (FIEs). As a result of these measures, Chinese trade increased from 1985 to 1995.

China next promoted and encouraged export development by joining the World Trade Organization (WTO) in 2001. Entry required China to further liberalize the trading sector of its economy by reducing tariffs as well as licensing and quota restrictions on both imports and exports (Lardy, 2002). China also loosened the restrictions on which companies are allowed to conduct trade and dropped the requirement that trading companies must partner with a state-owned enterprise (Lardy, 2002). These reforms allowed China to keep pace with how production and trade flows were changing as a result of the globalization of production. Because of the globalization of production, tradable goods were no longer wholly manufactured in one country. Instead, the individual components that constituted the final product were manufactured in different countries based on where it was most advantageous to produce that component. Enterprises then brought the different components together where they were assembled into the final product. China's pre-WTO trade restrictions didn't provide the necessary free movement of goods, and China was starting to lag as an exporter as a result (Lardy, 2002).

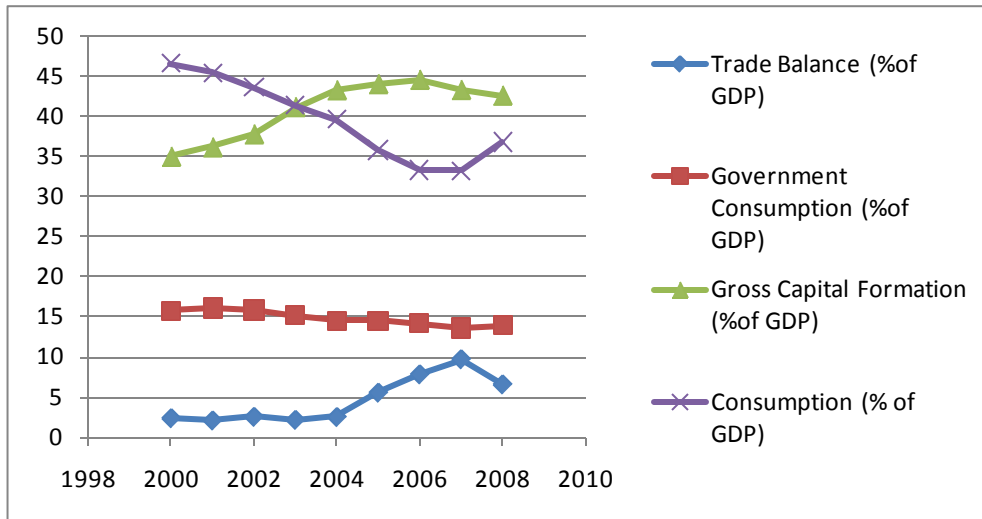


Figure 1: Chinese Growth

Source: World Bank World Development Indicators

Over the past decade China's investment and export-led growth model became more apparent. While government consumption remained largely flat, Figure 1 shows the increased importance of investment and a positive trade balance to the Chinese economy. This is particularly true since 2004, as investment rose to approximately 40% of GDP. China's trade balance increased as well, revealing the greater amount of resources that were channeled through investment into a positive trade balance. This is consistent with the BWII framework, as the high growth in exports ensures that new investment is globally competitive.

For China to pursue an investment and export-led growth model a high accumulation of capital is required. Capital is needed to provide funding for investment in new factories and infrastructure. In addition, following the global balance of payments

identity, a trade surplus is an excess of savings over investment (Razmi, 2008).

Therefore, a positive trade balance requires China to export its excess capital. Given China's high level of investment, it is remarkable that its savings rate is sufficient to fund both new investment as well as the savings necessary to finance a trade surplus.

One of the two main sources of this capital is FDI. China is one of the largest global recipients of FDI as 2008 inflows measured \$108 billion (UNCTAD, World Investment Report, 2009). In addition to funding, FDI provides positive externalities and allows China access to improved technology and managerial knowledge which are crucial to its development (Yao, 2006). Because of these externalities, the FDI contribution to China's economic growth is large and exerts a disproportionate influence on Chinese growth when compared to the size of the capital flows relative to GDP (Whalley and Xin, 2010).

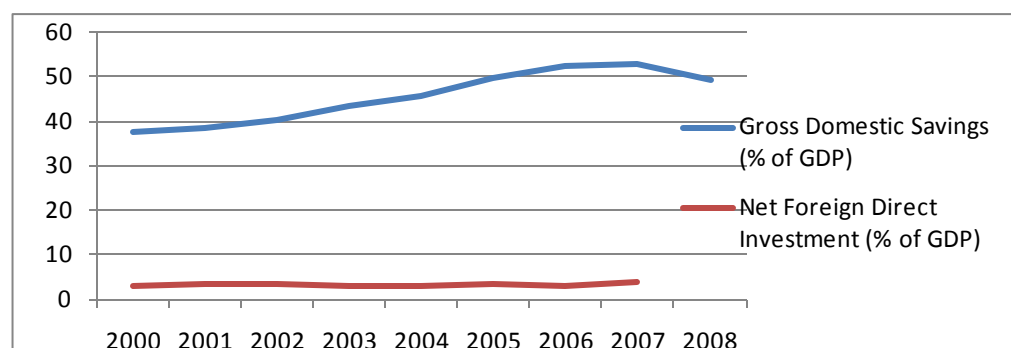


Figure 2: Chinese Savings

Source: World Bank World Development Indicators

The other dominant source of capital for the Chinese economy is domestic savings, particularly the savings of enterprises (Kuijs, 2005). First, enterprises are very profitable in China. This is due to the high rate of growth in output per worker (Bosworth and Collins 2008). In addition, Chinese firms are now more actively involved in the production of more sophisticated products which provide greater profit margins (Kuijs, 2005). Second, state owned enterprises (SOE) receive subsidies that allow them to export cheaper goods and reduce their costs. These subsidies can include utility discounts, free office space and favorable bank loans, among others (Eckhaus, 2005). In addition, reforms that passed in the mid-1990s restructured the SOEs and made them more profitable by removing many of the previous social obligations SOEs provided to workers including education and pensions (Chow, 2007). These developments lead to greater profitability, giving enterprises a greater capacity to save because they are drawing on a larger pool of profit. Third, China's inefficient financial sector is not developed enough to allow for enterprises to borrow at reasonable terms in the event that they are in need of financing. As a result, enterprises must aggressively save in order to be prepared for incidents that might require additional capital (Gao, Jin, Riedel, 2007). Finally, many Chinese firms do not issue dividends. This allows them to accumulate savings which are then funneled into more investment (Aziz, Cui 2007).

The Chinese economic system also increases enterprise savings and investment through the restraint of household income. Household income results from a number of sources, and in China each is institutionalized in a way that reduces household income and reduces domestic demand and consumption (Prime and Qi, 2009). First, economic growth and productivity increases are greater than household income from wages and

employment (Aziz and Cui, 2007). This results in Chinese workers facing a decline in the labor share of national income as more national income goes to enterprises (Aziz and Cui, 2007). Second, household income from investments and savings is low due to capital controls and financial repression. Capital controls limit the investment options for households to banks where the interest rate is controlled by the central government. These rates are set at a level that produces a negative real return (Lardy, 2008). Third, as mentioned above, despite their profitability enterprise saving is not distributed back to the government where it can be spent on social programs and income transfers. For example, in 2005 these transfers reached only half a percent of GDP (Aziz and Cui, 2007).

The large accumulation of savings retained by enterprises and the high amount of banking deposits are the two primary sources of capital for Chinese investment (Kuijs, 2005). A majority of this investment is done by enterprises, with fixed asset investment in manufacturing the dominant destination of investment (Barnett and Brooks, 2006). By allowing enterprises to retain their earnings and receive favorable conditions when borrowing from the financial sector, they shift resources and production towards tradables and exportable goods. This increase in China's manufacturing capability enables it to produce a higher amount of exportable goods. As a result of these efforts in 2008 China produced over nine percent of world goods exports, a marked increase from the three and a half percent it constituted in 1999 (Gaulier, Lemoine and Unal-Kesenci, 2007).

In order to further promote exports, China utilizes capital controls and financial repression that enable it to counteract the effects of an undervalued exchange rate. By acting to prevent the appreciation of the Yuan on international financial markets China

makes Chinese-produced goods cheaper and more attractive to consumers. However, China must purchase securities in the international financial market in order to counteract appreciative forces and maintain an undervalued currency. This step also increases the Chinese domestic money supply and necessitates monetary sterilization and financial repression in order to prevent inflation. In turn, capital controls are needed to prevent capital outflows attempting to find higher interest rates (Gao, Jin and Riedel, 2004). Financial repression includes a negative real rate of return on deposits in the Chinese banking system (Lardy, 2008). The buildup in reserves allow the banks to fund the high level of investment as well as purchase the government bonds issued to absorb liquidity from the economy and sterilize the inflationary pressures that could arise from an undervalued exchange rate.

As a result of these successful reforms China is one of the leading global trading countries. In addition, trade now constitutes thirty percent of the Chinese economy's yearly growth; up from a fifteen percent share during the 1990s (Guo and N'Diaye, 2009). Figure 4 illustrates the high amount of the Chinese economy that is involved in trade. In addition, China began to run significant current account balances that reached ten percent of GDP. While Figure 4 also shows the decline in trade that is the result of the global economic crisis, Chinese trade flows are rebounding with the monthly totals from the end of 2009 even exceeding their pre-crisis levels (World Bank, 2010).

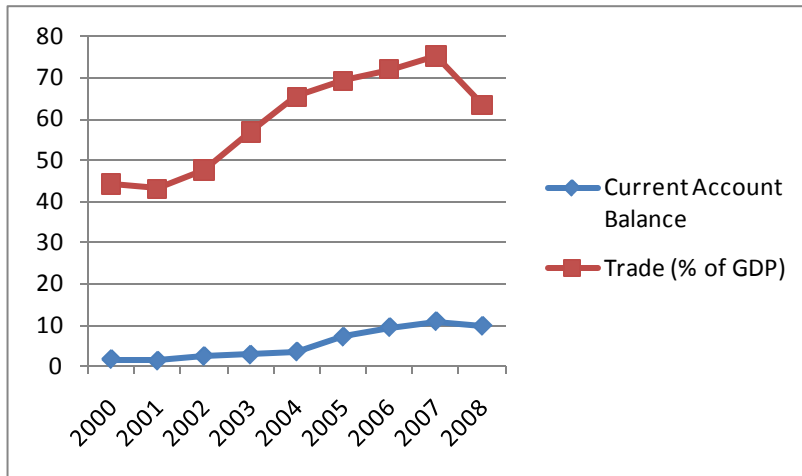


Figure 3: Chinese Trade and Trade Balance

Source: World Bank World Development Indicator

The purchaser of a large portion of China's increased trade was the United States. As the United States emerged from recession in 2001 and China entered the WTO, demand for Chinese products accelerated rapidly. Figure 4 reveals the large increase in American imports of Chinese products. After remaining sluggish in 2001, American imports expanded over 20% annually from 2001 to 2005. Even after slowing from this pace imports still increased 18% in 2006 and 12% in 2007 before slowing to 4.5% annual growth in 2008. Overall, by 2008 Chinese exports to the United States had increased 238% from their 2000 levels. Figure 4 also shows the decline that occurred in response to the global economic crisis. However, the decline was shallow and Chinese exports to the United States still remain large.



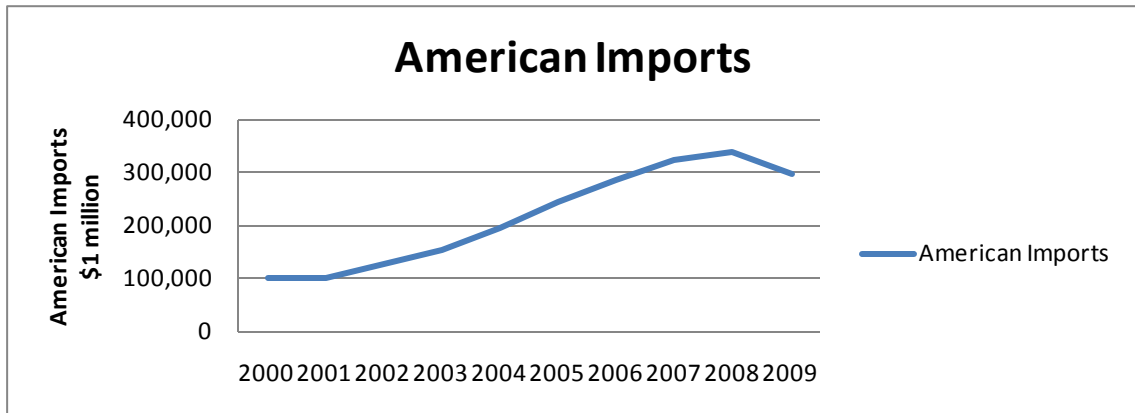


Figure 4: America's Chinese Imports

Source: United States International Trade Commission

## **CHAPTER III**

### **POLICY RESPONSE TO THE GLOBAL ECONOMIC SLOWDOWN**

The decline in output and shrinkage of trade initiated by the global economic crisis prompted Chinese leaders to craft a policy response in order to restart economic growth. To do so, Chinese authorities responded to the crisis with a policy of cutting interest rates and encouraging investment in manufacturing thereby supporting exports and investment. It is notable in this regard that Chinese policy remained consistent with its previous efforts to channel resources into exports and investment and that the economic crisis only worked to solidify this approach to economic growth in the Chinese economy.

After spending 2007 increasing interest rates in order to prevent overheating and slow the rapid growth of the Chinese economy, the Central Committee responded to the slowdown in external demand by instituting a loose monetary policy (Peoples Bank of China, 2009). This was achieved through a series of interest rate and demand deposit cuts. Interest rates are the only price mechanisms in the Chinese economy that are still centrally controlled (Gao, Jin and Riedel, 2004) and because of the immature development of China's capital markets, Chinese policymakers' efforts control the larger economy through loan growth are very effective (Dickinson, Ford and Sun, 2010). By lowering the interest rate, Chinese policymakers expand the pool of enterprises that can afford loans on those terms. This increases loan demand and loan volume while stimulating economic activity. Table 1 reveals that after raising rates six times in 2007, Chinese leaders cut rates five times in 2008. These cuts occurred in response to the

rapidly deteriorating economic climate. They show how quickly Chinese leaders switched to a loose monetary policy, even cutting rates twice in the month of October. Table 1 also shows that Chinese leaders reduced the rate of return on demand deposits. This was to maintain a sufficient spread between deposits and loans and allowed Chinese commercial banks to remain profitable. However, as mentioned earlier this financial repression has a negative impact on the incomes of savers and households and acts to restrict their demand and consumption growth.

	Demand	6 month	2 year	5 year	6-month	1 year	3 year	5 year
Date	Deposit	deposit	deposit	deposit	loan	loan	loan	loan
Jun-								
07	0.72	2.61	3.06	4.95	5.85	6.57	6.93	7.20
Jul-07	0.81	2.88	3.96	5.22	6.03	6.84	7.20	7.38
Aug-								
07	0.81	3.15	4.23	5.49	6.21	7.02	7.20	7.56
Sep-								
07	0.81	3.42	4.50	5.76	6.48	7.29	7.47	7.83
Dec-								
07	0.72	3.78	4.68	5.85	6.57	7.47	7.74	7.83
Sep-								
08	0.72	3.15	4.41	5.58	6.21	7.20	7.56	7.74
Oct-								
08	0.72	3.15	4.41	5.58	6.12	6.93	7.29	7.47
Oct-								
08	0.72	3.24	4.14	5.13	6.03	6.75	7.02	7.20
Nov-								
08	0.36	2.24	3.06	3.87	5.04	5.58	5.94	6.12
Dec-								
08	0.36	1.98	2.79	3.60	4.86	5.31	5.40	5.94

Table 1: Chinese Interest Rates and Demand Deposits

Source: Peoples Bank of China

	<b>Total</b>			
	<b>Amount of</b>			
	<b>Investment</b>			
	<b>in Fixed</b>			
	<b>Assets (100</b>	<b>Percent</b>		<b>Percent of</b>
	<b>million</b>	<b>Annual</b>	<b>Manufacturing</b>	<b>total</b>
	<b>yuan)</b>	<b>Increase</b>	<b>Investment</b>	<b>investment</b>
<b>2009 annualized</b>	202,360	37%	62,666	31%
<b>2009 through</b>				
<b>october</b>	168,634		52,222	31%
<b>2008</b>	148,167	26%	46,345	31%
<b>2007</b>	117,414	26%	35,497	30%
<b>2006</b>	93,472	24%	26,399	28%
<b>2005</b>	75,096	7%	20,319	27%
<b>2004</b>	70,073	26%	14,644	21%
<b>2003</b>	55,566	28%		
<b>2002</b>	43,499	17%		
<b>2001</b>	37,213			

Table 2: Chinese Fixed Asset Investment

Source: National Bureau of Statistics of China

China's policy to increase loan growth was successful. New RMB-denominated loans grew by 9.59 trillion. This was up 4.69 trillion, ninety-five percent annually, after growing by 4.9 trillion in 2008 (Peoples Bank of China, 2009). By September of 2009 the outstanding balance of loans in China reached 41.4 trillion after starting 2009 at 32.1 trillion (Peoples Bank of China, 2009a). These loans encouraged investment in fixed assets, particularly manufacturing. This rapid increase in loan growth also increased loans that financed fixed asset investment. Table 2 shows the growth in fixed asset investment. Even more important, Table 2 reveals that much of this investment growth was channeled into the trade-sensitive manufacturing sector.

Despite this growth in loans and speculative financial capital inflows- "hot money"- totaling \$73 billion in 2009, consumer inflation remains low and was even negative during 2009 (WB, CQU). The absence of significant inflation further bolsters the BWII case. If China's policy of increasing loan growth led to uncontrolled inflation and the rise of the wage rate this would prevent the gradual absorption of underemployed labor that is the basis for BWII. However, the proper functioning of capital controls and financial repression that prevent inflation and are needed for the survival of the BWII system remain intact and effective (Ma and McCauley, 2008). They allow China to maintain a currency peg in addition to an independent monetary policy.

Coupled with policies that funded a large increase in investment, Chinese leaders also adjusted their currency policy in response to the slowing global economy. After China allowed the Yuan to appreciate beginning in July of 2005, the Yuan left its peg of 8.3 Yuan to the US Dollar and reached a value of 6.8 Yuan/USD by June of 2008. It is this value that the Yuan is now re-pegged at, as the Yuan has not appreciated past 6.8

(Peoples Bank of China, Exchange Rate, 2010). As the economic crisis deepened, China resumed the Yuan to USD peg in order to continue to boost exports by delivering an undervalued currency. Maintaining the currency peg required the PBoC to raise its foreign exchange reserves by \$453 billion to \$2.4 trillion. Despite originating in the United States, the Chinese policy response to the global economic crisis further solidifies and supports the BWII thesis. Driven by an increase in manufacturing investment and the need for an export market, China will continue to act in the manner described by BWII and support American deficits to ensure access to the American market. Indeed, despite the difficulties in the American economy, the Sino-American trade balance still remains at over \$220 billion. This is greater than the levels of only a few years ago, as the trade deficit of 2005 totaled \$202 billion (United States International Trade Commission, Dataweb, 2009). Financially the United States' position as the dominant center country in the international economy remains strong, with US assets emerging as the safe haven during the crisis. In the case of China, it halted purchase of corporate bonds and equities and channeled its entire surplus of US Dollars into US Treasuries (Pandey and Setser, 2009).

In addition, further support for the large current account deficits between the United States and China is provided by the continuing efforts of American policymakers to stimulate American consumption. The overarching goal is to increase disposable income through a combination of transfer payments or tax relief to compensate for the declining private demand that result from job losses or a decline in income. In an open economy the inevitable side-effect is an increase in the consumption of Chinese products. The first attempt was the Economic Stimulus Act of 2008. The Act sent rebate checks to

American taxpayers in the hope that the increased income would arrest the decline in consumption and encourage economic growth. Individuals received \$600 dollars while married couples received \$1200 (H.R. 5140, 2008). There were payments to veterans and senior citizens as well as tax breaks for companies that purchased new business equipment. In total, the Economic Stimulus Act cost \$150 billion (H.R. 5140, 2008).

Following the Economic Stimulus Act, in 2009 American leaders enacted the American Recovery and Reinvestment Act (ARRA). ARRA provided a tax credits in an attempt to reduce the tax load and provide a higher amount of disposable income. Retirees receiving Social Security benefits and individuals on disability payments also received additional reimbursements. ARRA temporarily prevented the expansion of the alternative minimum tax (AMT) (H.R.1, 2009). Lastly, in response to rising unemployment numbers ARRA extended unemployment benefits (H.R. 1, 2009).

In addition to fiscal efforts to stimulate consumption, the Federal Reserve took steps to promote consumption by loosening the flow of credit to households. As credit markets froze, the Federal Reserve became an increasingly large financial intermediary. This occurred to facilitate the provision of credit including consumer credit from credit cards. Many credit card loans are bundled into asset-backed securities (ABS) and sold to investors through the process of securitization. The capital received from investors for purchasing these ABSs allows credit card lenders to continue providing new loans. However, with the disruption in the credit markets securitization had slowed. As a result, the flow of credit was halted, reducing many consumers' access to credit. In response, the Federal Reserve has instituted the Term Asset-Backed Stability Loan Facility (TALF) with the goal of aiding the securitization markets. By lending money to investors to



purchase ABSs, the Federal Reserve can free up consumer credit and encourage consumption (Federal Reserve, 2009).

## **CHAPTER IV**

### **IMPLICATIONS**

This paper argues that based on the policy response of China, the current economic crisis makes a stronger case for the existence of BWII to illustrate the patterns of trade and capital imbalances that are observed in the international economy. In addition, China's economic development model remains focused on exports and investment. At the same time the United States is still running large deficits and pursuing policies that require large capital inflows.<sup>3</sup> China requires the United States to be the final destination for its products and savings while the United States benefits from the low interest rates that China's capital inflows provide. This capital flow from the periphery to the center allows the United States to finance fiscal and current account deficits at lower interest rates while also receiving a premium on its assets relative to its liabilities (Gourinchas and Rey, 2005). As a result, the two sides are now in a state of codependency, where the costs of defecting from the existing relationship will cause economic disruption that is greater than the costs of maintaining the current state of the relationship. As a result, both countries will not take steps to end this relationship.

This leads to several policy predictions. First, this dependency reduces the ability of each side to pursue a policy of coercion. For example, the Chinese cannot attempt to gain leverage on the United States by threatening to halt China's purchase of American

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<sup>3</sup> The Congressional Budgetary Office estimates the American fiscal deficit for fiscal year 2010 to be \$1.3 trillion, 9.9% of GDP. The total predicted deficit for fiscal years 2011 to 2015 is \$3.12 trillion. (CBO,

debt. There are a number of reasons for this. Pursuing an exports and investment-led growth model requires China to continue to purchase American debt. It is in China's interest to purchase these securities in order to prevent a rise in American interest rates. A rise in interest rates would reduce American economic growth and thereby lower consumption of Chinese products. At a time when Chinese domestic consumption remains subdued because of financial repression and the European economy is struggling (Donadio, 2010, February 9) China doesn't have alternative locations to sell its products and needs the United States market. A dispute that provokes American tariffs and restrictions on Chinese goods would severely impair exports at a time when China is especially economically vulnerable. As a result, China's leverage is limited because it would expose itself to economic damage and is vulnerable to retaliation. Second, the United States is not solely dependent on China for its deficit financing. The United States is the largest economy in the global economic system with a highly liberalized financial system that provides it access to alternative sources of funding (Drezner, 2009). The United States would have the ability to tap many different sources of credit if the need arose. Third, China lacks the skills and ability to diversify its large foreign exchange reserve holdings (Hananman and Rosen, 2009).

Furthermore, it is likely that the United States would emerge the less impacted of the two countries if an economic dispute were to erupt. The Chinese economy is more sensitive and exposed to trade. The aggregate trade value in 2009 between the United States and China was \$360 billion (United States International Trade Commission, Dataweb, 2009). With an economy valued at approximately \$14 trillion for the United States versus \$4.4 trillion for China (World Bank, World Development Indicators, 2008),

the percentage of the United States economy involved Sino-American trade is significantly smaller than that of China. Hence, a trade disruption is likely to have a more significant impact on the Chinese economy than on the American one especially after considering that as the wealthier state, the United States would have a greater amount of resources with which to endure an economic disruption.

Even though the United States and China will remain economically dependent, it doesn't follow that the two nations will not experience economic tension. China's expansionary monetary policy that increases investment will also generate extra capacity for production that translates into greater exports (Dickinson, Ford and Sun 2010). At a time of economic hardship in the United States this is likely to provoke a protectionist political response (Buckley, 2010, February 10). In addition, President Obama has recently remarked that a goal of his administration is to increase American exports (Cooper, 2010, January 28). This could create additional friction on trade levels and China's undervalued Yuan policy if the United States pushes to weaken the USD in order to encourage exports. There is a potential risk that China and the United States accidentally fall into a disastrous economic dispute. It could be driven by difficult economic times that generate political pressure on Chinese and American leaders to slow the flow of trade and capital between the two countries.

Lastly, China will continue to be hesitant in moving away from an undervalued currency peg in order to ensure that its goods remain attractive on the international level. In addition, if China does allow the Yuan to appreciate, it will be slow and measured, similar to the appreciation that occurred between 2005 and 2008. With the United States and Europe, the two largest markets for Chinese goods, continuing to have economic

difficulties Chinese leaders will be hesitant to allow the Yuan to appreciate too soon and too quickly because of the negative price impact on exports. Furthermore, per the BWII framework China can allow the Yuan to gradually appreciate yet remain on its optimized wage growth path through the control of wages and inflation. As a result, the same net capital and trade inflows will still be generated.

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